$50.00 ANNUALLY
40 Letters Per Year

DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
P. O. Box 15196
San Diego 15, California

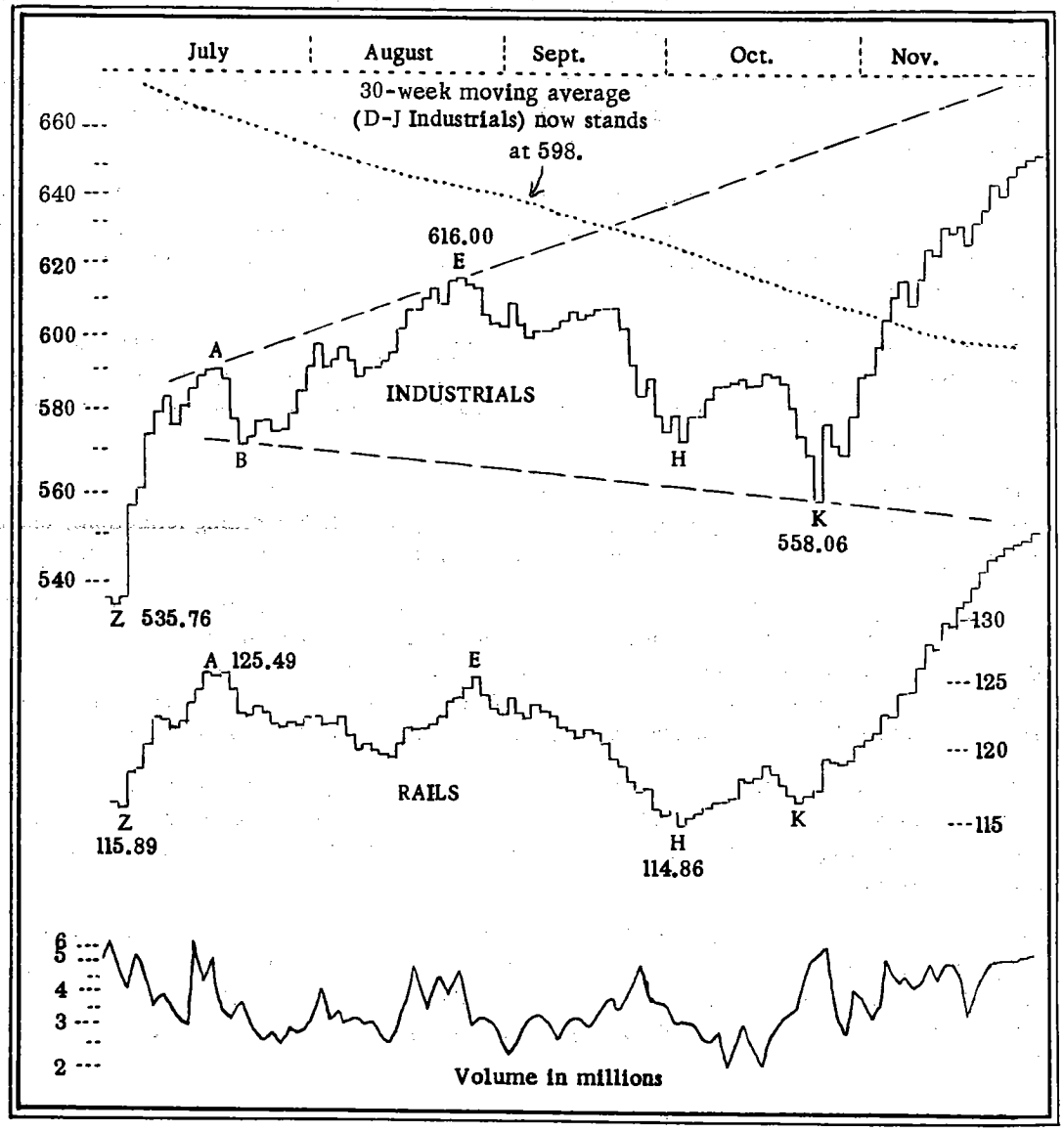
Registered with the Securities and Exchange Commission

Letter 201 seems to have set off a flood of well-meaning comment. Many subscribers cautioned me against admitting fallibility in public, and a few individuals warned that "my other subscribers" would not understand "this type of Letter." I appreciate all the kind words, but from my own experience I know that my readers (1) tend to be far above average, (2) do not expect perfection (3) want above all else to learn. A good friend and excellent market student writes that "You, for some reason, elected to blame yourself instead of putting the blame where it belongs. Technical studies, under present development (high as it is), could not give a strong enough probability for what happened. In fact, the balance was slightly in reverse. It was confusing to all of us and is still confusing." He adds: "Naturally, the brotherhood of bulls (I mean the kind who rode down through 1960 and the spring of 1962) 'saw' the turn. They always see the turn! Everyone with a set of prejudices is sooner or later right."

So much for retrospect and its repercussions. The professional trader must harness his natural inclination to "play every hand." Perhaps the professional soothsayer must harness his own wish to "catch every swing on the button." In the final analysis -- it simply cannot be done.

THE MARKET On November 9 the two Averages bettered their preceding secondary highs, and at that time (Letter 200) the existence of a mechanical bull signal was recognized. Last week (November 27) the advance-decline ratio rose above its August 23 recovery peak. The possibility of an upside non-confirmation between price and breadth (see Letter 201) was thereby eliminated. During the 24 trading days since October 23, the Industrials have embarked on a spectacular vertical climb which has added 16% to the value of the senior Average. Rails have not only been "in gear" with Industrials but have actually outperformed them on a percentage basis.

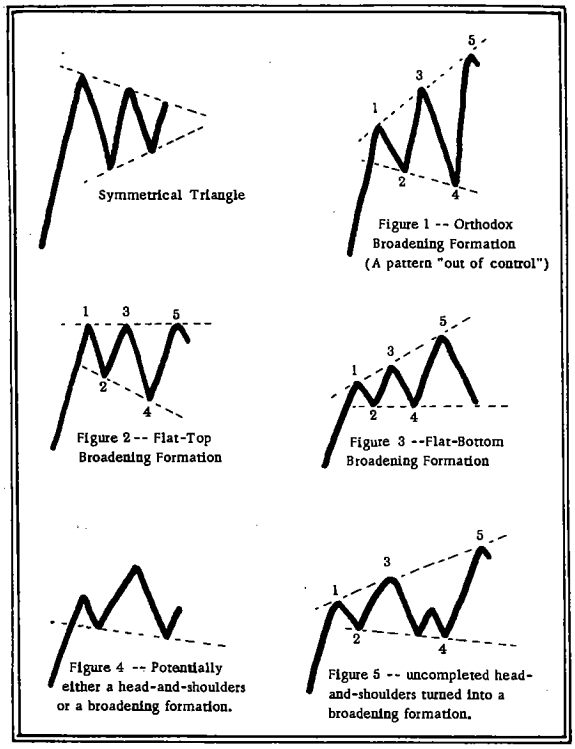
In order to compare the current rise with one of equal intensity, it is necessary to go back to the (post-crash) June-July, 1938, period. At that time Industrials advanced from 114 to 144 (26%) within the remarkably short period of 30 trading days. Following the July 25, 1938, peak of 144.91, the Averages rounded over into a sliding consolidation which lasted until late September.



A final spurt began from the 129.91 low of September 26, 1938, and this rise took Industrials to a ("baby bull market") peak of 158.41. That peak stood for seven years (until 1945).

Of the mid-1938 advance Robert Rhea wrote the following (June 25, 1938): "Within my memory I cannot recall an advance similar to that of this week. The breadth and character of the rally and expansion of activity has been most impressive, and the occasional dips usually caused by profit taking have been negligible... But fast rallies and rapidly expanding volume cannot continue forever. Great upward velocity tends to inflame speculative fever, and ultimately breeds a reaction, the severity of which is always somewhat in proportion to the type of advance. When a reaction will develop we cannot tell. The movement might carry to unexpected levels before a crash."

It is worth noting that in advances of the current type (and of the type witnessed by Rhea) the first downward correction is usually not the "real McCoy." More often than not, a second rise will succeed in taking the Averages above the peak level of the first "explosion." The second rise, however, is usually the distribution phase, and it generally offers more frustrations than profits.


Symmetrical Triangle
1
2
3
4
5
Figure 1 -- Orthodox Broadening Formation (A pattern "out of control")
Figure 2 -- Flat-Top Broadening Formation
Figure 3 --Flat-Bottom Broadening Formation
Figure 4 -- Potentially either a head-and-shoulders or a broadening formation.
Figure 5 -- uncompleted head-and-shoulders turned into a broadening formation.

"WILD AND WOOLY" Letter 201 called attention to the "broadening formation" which has now appeared in the Industrial Average. Broadening formations are also appearing in the charts of many individual stocks. Because of the uniqueness of these patterns and because the very appearance of broadening formations tells us something about the character of the market which produces them, I feel that a thorough discussion of the broadening phenomenon is warranted at this time.

As stated in the last Letter, broadening patterns are indicative of a market which is "out of control." These formations are associated with markets (or individual stocks) which are being whipped about by rumors, violent reversals in investor psychology, and rapidly changing areas of technical strength and weakness.

If the well-known symmetrical triangle (see above chart) is suggestive of a controlled period of distribution or accumulation (each of the rallies and declines within the symmetrical triangle is smaller than the last), the broadening formation represents a period of whip-sawing, uncontrolled gyrations. The broadening formation, in fact, may be likened to a symmetrical triangle in reverse.

Essentially, every broadening formation is a five-point reversal pattern with each high above the last high and each low below the previous low. The formation is completed when, after the fifth reversal, the pattern turns down and breaks below the fourth reversal point. Volume during the final decline is usually heavy (although volume may be erratic or heavy throughout the broadening formation).

There are three types of broadening formations: the orthodox broadening pattern in which the upper trendline rises and the lower trendline slants down (figure 1, above); and the right-angle broadening formations, one being a broadening pattern with a flat top (figure 2), and the other being a broadening pattern with a flat or horizontal bottom (figure 3).

Writing of orthodox broadening formations, Edwards and Magee ("Technical Analysis of Stock Trends") note that "nine times out of ten they carry bearish implications." Of right-angle broadening patterns Edwards and Magee remark: "Generally speaking, right-angle broadening formations carry bearish implications, regardless of which side is horizontal, in nearly the same degree as the symmetrical manifestation." This writer has noticed that where a broadening formation does break to the upside, the action is usually wild and erratic (and often accompanied by many gaps).

In the symmetrical triangle (representative of "controlled" action) most of the movement is confined within the area of the converging trendlines. But in a broadening ("uncontrolled") pattern the trendlines are often either not met or surpassed with each successive swing. In other words, a broadening formation seldom produces the "clean", symmetrical appearance which is such a remarkable characteristic of most other chart formations.

One of the commonest and most reliable distribution formations is the well-known "head-and-shoulders" top. In order to comprehend the meaning of the broadening formation, it is necessary to understand Edwards and Magee's statement that "every head-and-shoulder begins as a broadening formation." When, during the formation of a head-and-shoulder pattern, the right shoulder enters a sustained rallying phase and surpasses the head — we then have a broadening pattern (figures 4 and 5, on chart above).

Two further concepts should be understood in connection with head-and-shoulder and broadening formations. Concerning the appearance of uncompleted head-and-shoulder patterns Edwards and Magee write: "A head-and-shoulder pattern which does not 'work' is a warning that, even though there is still some life in the situation, a genuine turn is near. The next time something in the nature of a reversal pattern begins to appear on the charts it is apt to be final." In other words, the appearance of a head-and-shoulder (completed or not) is a warning of things to come. When such a head-and-shoulders is followed by a rally, a broadening formation is almost surely in the making.

The second point is that in order to have a broadening effect, there must be (and this may sound paradoxical) a strong technical situation within a bearish price structure. For it is exactly this strong technical situation which allows and indeed produces the fifth upward leg of the broadening formation (instead of allowing for a completed head-and-shoulders pattern — with accompanying immediate weakness).

As I see it, the recent market action suggests a strong technical situation within an overall bearish broadening pattern. The pattern of the Industrial Average during July to October implied distribution. The head-and-shoulders formation in the Industrial Average and in the pattern of many individual stocks should ordinarily have served as a warning. Yet an increasingly powerful technical undercurrent prevented those patterns from being completed, and the result was the "explosion" which followed the October 23 low. Instead of completed head-and-shoulders patterns, we now see broadening formations in the Industrial Average and in many leading issues. The existence of such formations should be taken as a warning of a potentially dangerous situation — a situation which is not normally conducive to long-term investing or intelligent accumulation.

Broadening formations are a rare chart phenomenon. They are seldom seen in the patterns of individual stocks and are even more rarely seen in one or the other Average. In the long history of the D-J Averages, I can find only a few places where broadening formations have occurred.

A broadening formation began in June, 1919, and was completed in November of that year. The formation proved to be bearish and the November peak terminated the bull market of 1917-19.

A broadening "tendency" developed in the Industrial Average during January to May, 1929, but the formation was not completed. The great analyst and market student, Richard Schabacker, took careful note of this formation and later wrote a chapter in his book (Stock Market Theory and Practice) under the heading: "Why the Bull Market Almost Ended in May, 1929." In describing the wild gyrations of 1929, Schabacker wrote that when the Industrials struck their fifth (broadening) reversal point and turned down, they did not break below the preceding fourth reversal point. A new rally thereupon took the Industrial Average into new high ground, "thus saving the technical indications for the bull cause." The uncompleted broadening formation of mid-1929 carried a warning, however, and that warning was served two months later.

The third broadening formation occurred in the Industrial Average during the May-August, 1957 period. This formation was completed and it was followed by a 100 point drop (July-October, 1957). Thus, in the history of the Averages there have been only two completed broadening formations, 1919 and 1957.

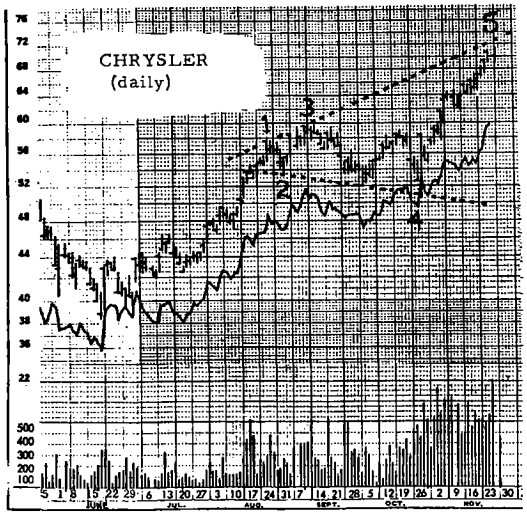
LATE NOTES (written Thursday, November 29, after the close). The past few days have produced volume in the 6 million share range. The market is "overbought", and it is taking greater and greater quantities of "steam" (volume) to keep the "boiler's gauge rising." I told an eager friend that "to buy them here is tantamount to playing craps at Las Vegas. He smiled: "I was there last week and came out ahead." My answer was that "I have to deal with probabilities in this business. Probabilities are against buying and making money over the next month vs. buying and losing money. When you go to Vegas, you expect to lose a few dollars in return for a good time. When you put your money in an 'overbought' market, you'll probably lose it — and you lose it without benefit of 'the good time'".

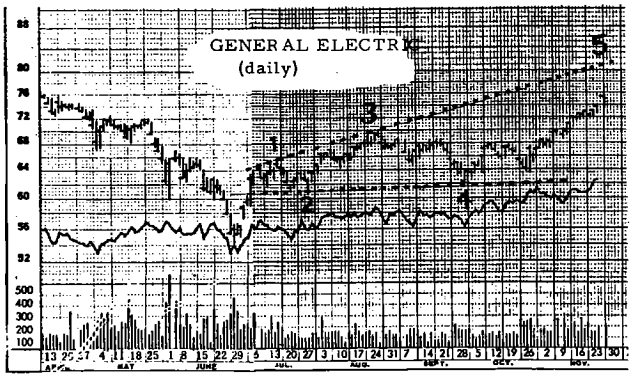
STOCKS Of our 346 representative stocks, 152 or 44% are now above their own 30-week moving average. This is a rise of 8% since the last Letter but still less than a majority of issues. Strangely, of the same 346 stocks, only 125 are now above their August peaks (at which time the Industrial Average was 616.00).

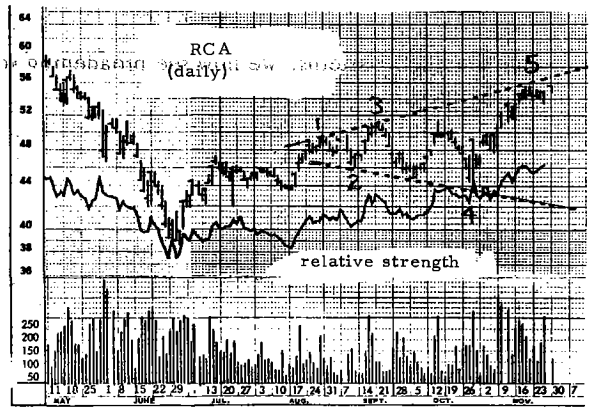
Violent markets are often the hardest to make money in. Rotation from one stock to the other can be swift and ruthless, and "the winner" one week can be "a dog" for the rest of the upswing. It appears to me that many issues are now in patterns which suggest the formation of giant triangles or rectangles ("boxes") of either accumulation or distribution. Should a period of general consolidation now occur, it will be most important to watch the charts of leading issues.

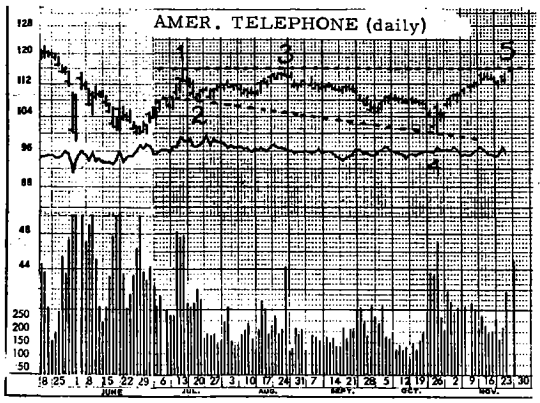
For instance, IBM (see chart on page 4) turned "on a dime" at the June low, rallied to the 416 high of August, fell back to the October low of 320, and has since rallied (but not above its August high). A triangle (dotted line) may now be forming. The same potential pattern is appearing in a great many other issues. The "breakout" from these patterns (either up or down) will probably provide the best clue as to the next major direction of the market.

A rise above the triangle formation (on increasing volume) would suggest that a new upward swing is "in the cards." In my opinion, this would be the safest time to make speculative commitments (i.e., as the stock breaks out of a large recognizable pattern.) On the other hand, a break below the triangle would signal important trouble ahead — and very likely a resumption of the bear market.

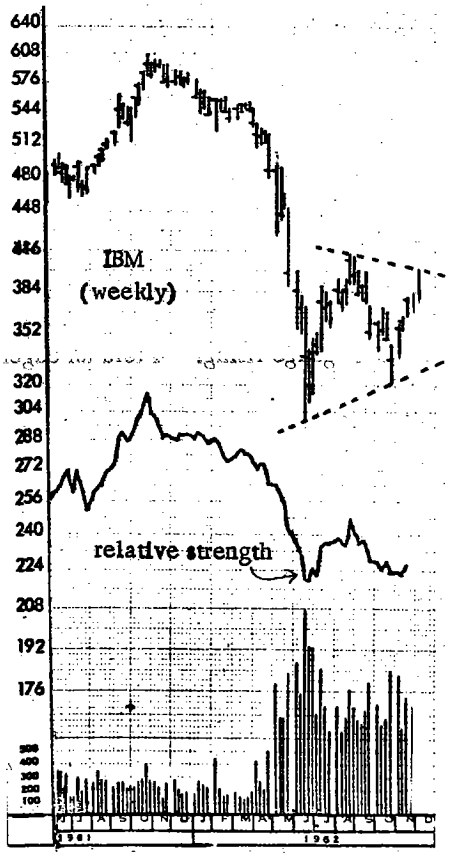








For purposes of illustration I have shown the charts of four leading stocks — all in broadening patterns. Three of the patterns are orthodox broadening formations, while the fourth (Amer. Telephone) is in a flat-top broadening pattern. The five reversal points are marked. In no case has one of these stocks turned down from its fifth reversal point. So far, however, the upper trendlines have served to arrest the advances.



ANNOUNCEMENT The mailer which accompanies this Letter describes an album which the writer and his friends at Traders Research have been preparing. This is the first time that daily (and weekly) historical charts of the A-D ratio have been made available. I believe that these charts will make an absolutely invaluable addition to every technical library. We are printing a limited number of copies for release about mid-December. Up to this time, I have had to use monthly (high-low) charts of the A-D ratio for my own historical work, and I am as anxious as many readers are to avail myself of the daily and weekly graphs. Please make all checks payable to Richard Russell, and send checks to P. O. Box 15196, San Diego 15, California. Knowing Traders Research and their work, I am sure that the charts will be both artistic and accurate.

Charts on this page courtesy of Traders Research, P. O. Box 2466, St. Louis 16, Missouri.